

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:LN:TL-N-2285-99

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date: APR 13 1999

to: Chief, Examination Division, Southern California District
Jerry Wolcott, E:1411

from: District Counsel, Southern California District, Laguna Niguel

subject: [REDACTED]

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ISSUE

Whether interest payments made by the taxpayer to [REDACTED] subsidiaries of the taxpayer's [REDACTED] parent corporation should be treated as if made directly to the parent for purposes of the tax imposed by I.R.C. § 881 (and thus the withholding requirements of section 1442 and the liability rules of section 1461).

CONCLUSION

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FACTS

The taxpayer, [REDACTED], is the U.S. subsidiary of a [REDACTED] parent, [REDACTED], based in [REDACTED]. The taxpayer is a holding company and is the parent corporation of [REDACTED] U.S. subsidiaries. In [REDACTED], [REDACTED] borrowed money from [REDACTED] banks and then contributed the borrowed funds to two subsidiaries, one in the [REDACTED] [REDACTED] and another in the [REDACTED] [REDACTED]. The funds were contributed as equity--not loaned. [REDACTED] made an interest free loan of most of its equity to [REDACTED], and [REDACTED] loaned those funds plus most of its own equity to the taxpayer. The taxpayer paid interest on this loan at a rate of prime plus [REDACTED]%. The taxpayer treated these payments as exempt from withholding requirements under the U.S.-[REDACTED] treaty as then in existence. No Forms 1042 were filed. The taxpayer also deducted the interest payments. For the first few years, [REDACTED] promptly loaned the amount of the interest payments, and more, back to the taxpayer.

It appears that during [REDACTED] and [REDACTED], [REDACTED] stopped lending money to the taxpayer, even amounts to cover the interest, and the taxpayer began repaying the principal of the loans. The principal amounts went from an apparent high of \$[REDACTED] at the end of [REDACTED] to a low of \$[REDACTED] at the end of [REDACTED]. At the end of [REDACTED] the U.S.-[REDACTED] treaty was amended to remove the exemption from the withholding requirements. After [REDACTED] [REDACTED] and [REDACTED] were sold to a [REDACTED] bank for an unknown amount.

[REDACTED] and [REDACTED] appear to have engaged in no business activities other than the loans and some hedging activities. The remainder of their expenditures are minuscule amounts relating to rent, taxes, salary, management fees, etc.--the usual overhead items for a small office.

The taxpayer's years under audit are [REDACTED] through [REDACTED]. The taxpayer filed no Forms 1042, thus, if the withholding rules apply, the statute of limitations will be no bar to assessment. The statute of limitations on assessment relating to the taxpayer's income tax returns for those years has expired,

however. Thus an adjustment to the interest deduction is no longer possible.

The taxpayer has made several arguments relating to its business reasons for creating the [REDACTED] entities. First, taxpayer has argued that the entities were created to act as holding companies for future acquired European subsidiaries. Although there is documentary evidence of investigation of potential acquisitions in [REDACTED] none were acquired. Second, the taxpayer realized a profit when [REDACTED] was sold to a [REDACTED] bank. The taxpayer has argued that this profit constitutes a business purpose. Third, the taxpayer has argued that the existence of the [REDACTED] entities were useful for public relations purposes in a private placement of preferred shares to [REDACTED] and [REDACTED] investors. The existence of a [REDACTED] subsidiary supposedly comforted potential [REDACTED] investors. Fourth, the taxpayer has also argued that it had [REDACTED] tax motivations for creating these entities. The taxpayer argues that this structure helped it avoid annual [REDACTED] Federal and [REDACTED] capital taxes as well as annual [REDACTED] Federal and [REDACTED] income taxes.

The [REDACTED] Federal and [REDACTED] governments imposed taxes on the capital of a corporation totaling [REDACTED]% or less for the years at issue. By keeping the interest earned in the [REDACTED], [REDACTED] avoided adding it to its retained earnings and thus, supposedly, avoided an increase in its capital taxes for those years. With regard to the income tax, the taxpayer argues that [REDACTED] benefitted from [REDACTED]'s system of exempting dividends from foreign countries--although no credit is given for any foreign withholding either. The taxpayer has not shown that the [REDACTED] withholding would have been less than U.S. withholding. Finally, the taxpayer argues that [REDACTED] benefitted by deferring any capital gains income on disposition of foreign assets. It does not appear, however, that any foreign assets related to the [REDACTED] corporations were ever sold until the [REDACTED] corporations themselves were sold.

LAW AND ANALYSIS

I.R.C. §§ 871 and 881 generally impose a tax of thirty percent on interest income received by a nonresident alien or foreign corporation from sources within the United States.¹

¹ Section 871. Tax on nonresident alien individuals

(a) Income not connected with United States business--30 percent tax.--

United States sources who pay such interest generally are required to deduct and withhold a tax equal to thirty percent of the amounts they pay. See sections 1441(a) and (b).² If they fail to do so, they are liable for the withholding tax. See section 1461.³ Under this statutory framework, the taxpayer

(1) Income other than capital gains.--Except as provided in subsection (h), there is hereby imposed for each taxable year a tax of 30 percent of the amount received from sources within the United States by a nonresident alien individual as--

(A) interest (other than original issue discount as defined in section 1273), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income. ...

Section 881. Tax on income of foreign corporations not connected with United States business

(a) Imposition of tax.--Except as provided in subsection (c), there is hereby imposed for each taxable year a tax of 30 percent of the amount received from sources within the United States by a foreign corporation as--

(1) interest (other than original issue discount as defined in section 1273), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income. ...

² Section 1441. Withholding of tax on nonresident aliens

(a) General rule.--Except as otherwise provided in subsection (c), all persons, in whatever capacity acting (including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States) having the control, receipt, custody, disposal, or payment of any of the items of income specified in subsection (b) (to the extent that any of such items constitutes gross income from sources within the United States), of any nonresident alien individual or of any foreign partnership shall (except as otherwise provided in regulations prescribed by the Secretary under section 874) deduct and withhold from such items a tax equal to 30 percent thereof.

...
(b) Income items.--The items of income referred to in subsection (a) are interest (other than original issue discount as defined in section 1273). ...

³ Section 1461. Liability for withheld tax

would have been required to withhold tax on the interest it paid if it had been paid directly to [REDACTED]

The Code also provides, however, that, to the extent required by any treaty obligation of the United States, income of any kind is exempt from taxation and excluded from gross income. See section 894.⁴ During the years at issue, Article [REDACTED]

[REDACTED]

" See Convention with Respect to Taxes on Income, United States-[REDACTED]

[REDACTED]. Based on this provision, the taxpayer did not withhold tax on its interest payments to Finance.

Under the terms of the Treaty, interest on a note that is "derived from" a United States corporation by a [REDACTED] corporation is exempt from United States taxation. The question is whether this interest was actually derived by a [REDACTED] corporation, or if the [REDACTED] corporation may be ignored under either a sham transaction theory or a substance over form theory.

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Every person required to deduct and withhold any tax under this chapter is hereby made liable for such tax and is hereby indemnified against the claims and demands of any person for the amount of any payments made in accordance with the provisions of this chapter.

⁴ Section 894. Income affected by treaty

(a) Treaty provisions.--

(1) In general.--The provisions of this title shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer.

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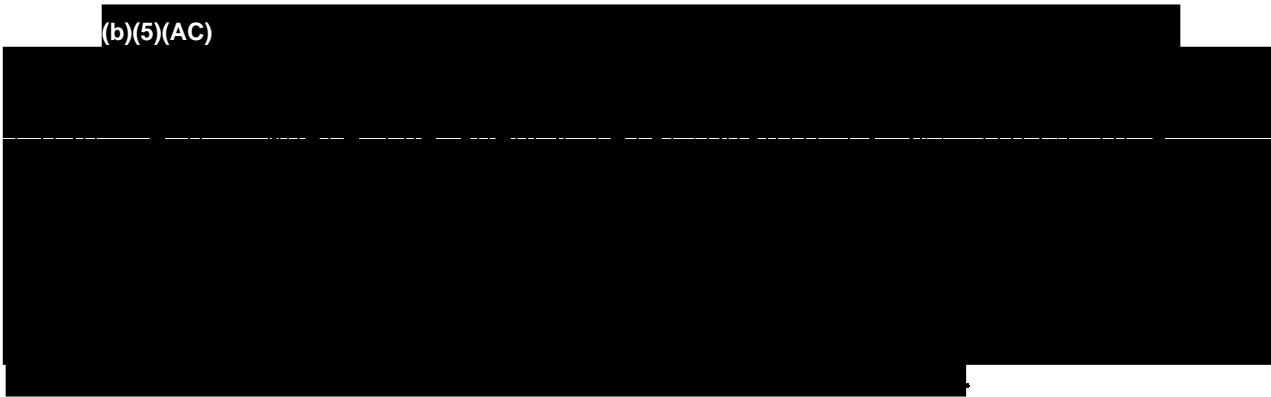
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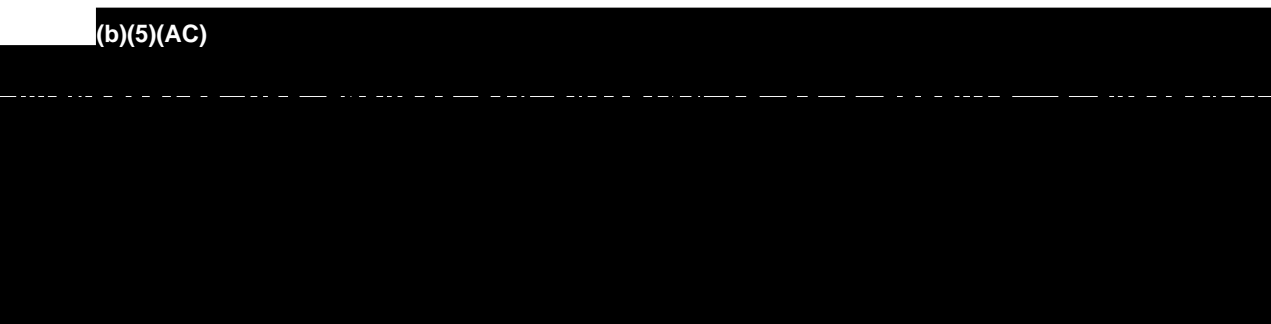
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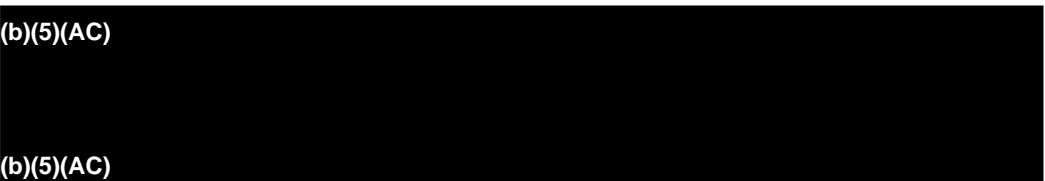
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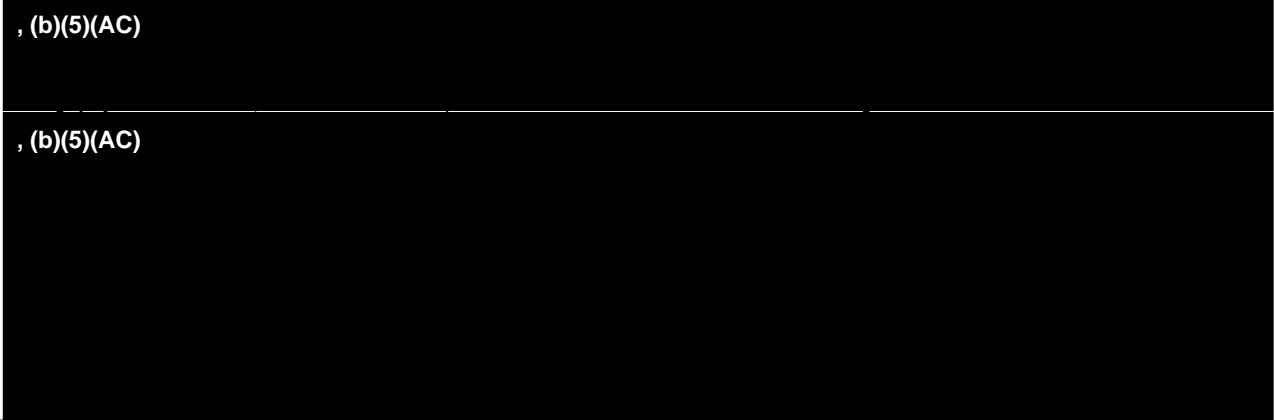
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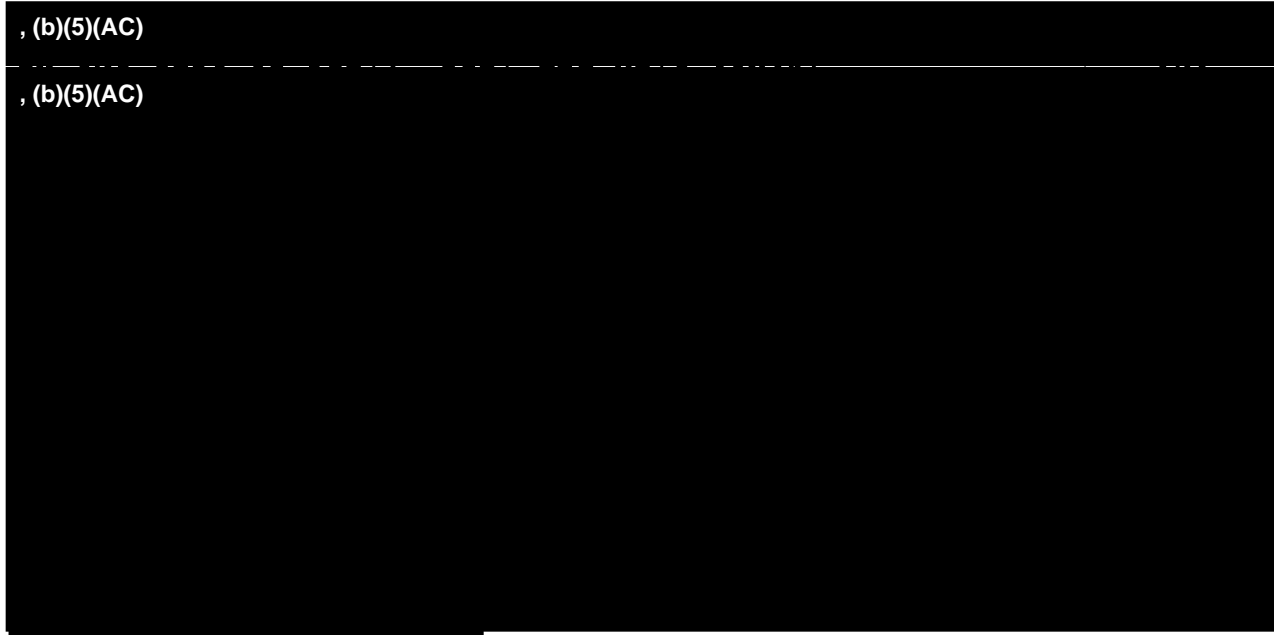


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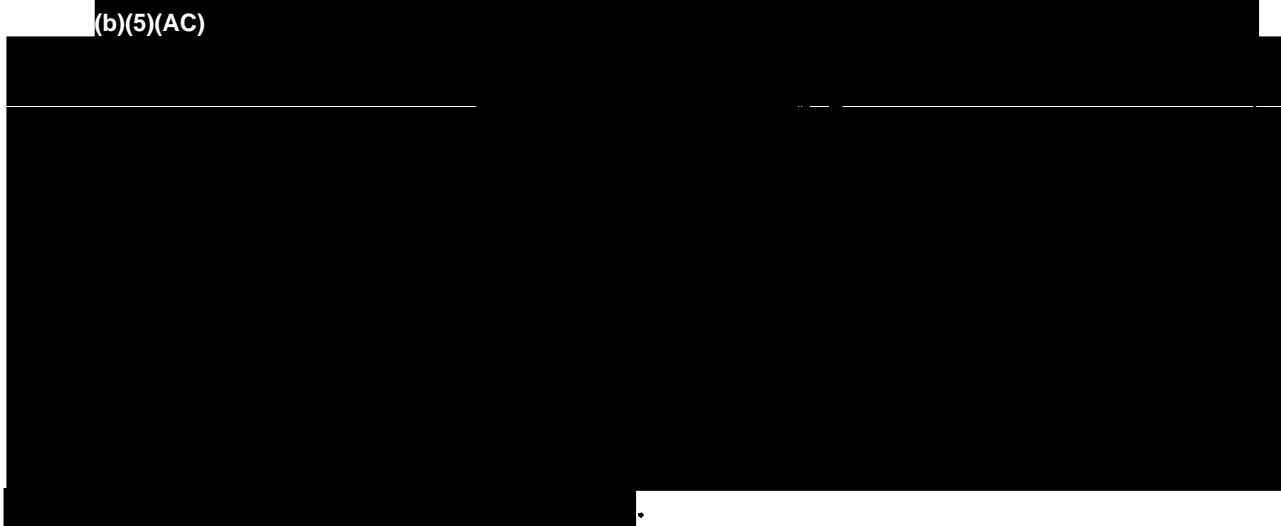
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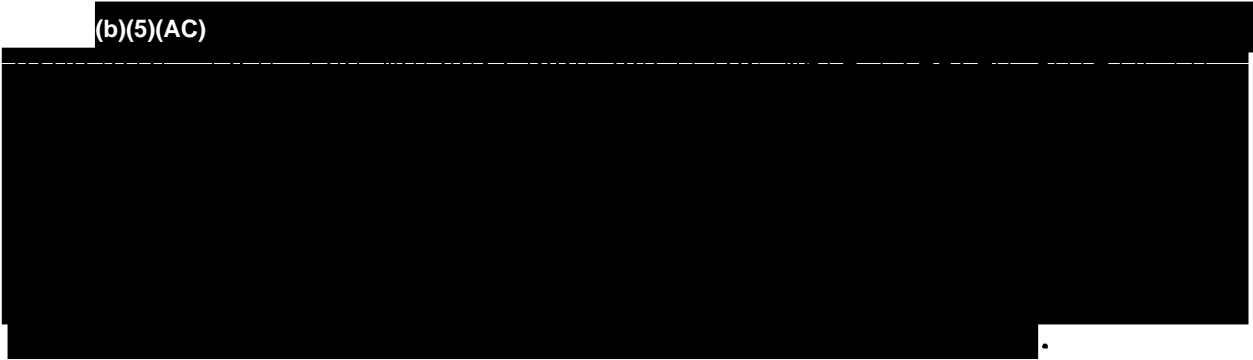
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CONCLUSION

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J. SCOTT HARGIS
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